UNAPPROVED MINUTES
of the
FOURTH MEETING
of the
TOBACCO SETTLEMENT REVENUE OVERSIGHT COMMITTEE

September 24-25, 2009
State Capitol, Room 311

Present	**Absent**
Rep. Gail Chasey, Co-Chair	Sen. John C. Ryan
Sen. Mary Jane M. Garcia, Co-Chair	
Sen. Dede Feldman	
Rep. Danice Picraux	
Rep. Gloria C. Vaughn	

Advisory Members	
Sen. Rod Adair	Sen. Sue Wilson Beffort
Rep. Karen E. Giannini	Rep. Ray Begaye
Sen. Linda M. Lopez	
Sen. Mary Kay Papen	

Staff
Sandy Mitchell, Staff Attorney, Legislative Council Service (LCS)
Michael Hely, Staff Attorney, LCS
Roxanne Knight, Researcher, LCS

Guests
The guest list is in the meeting file.

Handouts
Copies of all handouts and written testimony are in the meeting file.

Thursday, September 24

Committee Business
The fourth meeting of the Tobacco Settlement Revenue Oversight Committee (TSROC) for the 2009 interim was called to order as a subcommittee by Representative Chasey, co-chair, on Thursday, September 24, 2009, at 10:12 a.m. in Room 311 of the State Capitol in Santa Fe. At 10:34 a.m., a quorum was achieved.

Update on Legislation, Litigation and Arbitration from the Office of the Attorney General

Deputy Attorney General David Thomson introduced himself and Attorney General's Office staffers Nan Erdman and Claudia Ravenelli. He informed the committee that he intended to cover several issues previously raised by committee members.

First, Mr. Thomson informed the committee that tobacco manufacturers have filed suit against the federal government in a case titled *Commonwealth Brands v. U.S.A.*, alleging that the new federal Family Smoking Prevention and Tobacco Control Act (FSPTCA) violates the tobacco manufacturers' constitutional rights by restricting certain commercial speech, such as the provisions that prohibit the use of colored lettering and other advertising restrictions. The tobacco manufacturers argue that anti-tobacco messages and the shocking imagery that the FSPTCA mandated upon the top of cigarette packs inhibits their ability to communicate with adult consumers.

The New Mexico attorney general may file an amicus — friend of the court — brief alongside other states' attorneys general, via the National Association of State Attorneys General, in this matter. The attorney generals' concern is with health. At this early stage, 10 states have joined.

Mr. Thomson then provided an update on federal arbitration. New Mexico is in a dispute with a number of tobacco manufacturers regarding what they owe the state for 2003, and this matter has been referred to arbitration. The tobacco manufacturers argue they owe less than New Mexico demands because the state has not enforced the Master Settlement Agreement (MSA) against nonparticipating manufacturers. Mr. Thomson explained the arbitration process to the committee. He informed the committee that three arbitrators will be picked on November 1, 2009. It will be a full trial-like adjudication and an enormous, costly task, according to Mr. Thomson. The arbitration will likely go forward after July 2010. Mr. Thomson is serving on a negotiating committee as to the arbitration process. He predicts a three-month arbitration. Two former White House counsel are opposing Mr. Thomson. It may be a regional arbitration, dividing the country into sections; or it may be national, meeting in a larger city. Due to the size of the litigation, it will likely be in a number of locations.

New Mexico believes it has enforced the MSA. The tobacco manufacturers must show that New Mexico has been noncompliant. New Mexico is also a plaintiff, alleging that tobacco manufacturers have themselves breached the MSA.

Compliance with the MSA is a quasi-strict-liability situation. New Mexico gets a portion (an "allocable share") of the annual tobacco settlement payment. Each state will be separately determined to have either complied or not. One possible outcome could be that a state loses its entire allocable share. If New Mexico is found to have not been diligent, the state must pay back a portion of the tobacco settlement money it received in 2003.

Tobacco manufacturers are trying to recover what they have paid to states. Participating manufacturers signed a contract with the MSA. In negotiations, New Mexico had taken the position that nonparticipating manufacturers are still causing harm and must make restitution for Medicaid costs, etc., incurred by states as the result of their residents' use of nonparticipating tobacco manufacturers' products. Nonparticipating manufacturers must deposit money into escrow, make it secure and accurately account for the amount of sales in the state. If a state wants to recover that money, it is there.

The arbitration in which New Mexico is currently a party is with participating manufacturers. New Mexico and the other states in the arbitration must show that participating manufacturers are on a "level playing field" in the market shared with nonparticipating manufacturers; *i.e.*, that the states' actions have not placed the participating manufacturers at a disadvantage for complying with the MSA.

New Mexico's compliance through legislation was explained. State attorneys general had recommended that each state pass model legislation to comply with the MSA. For example, Representative Chasey carried a bill that requires stamps on all cigarettes, whether tax-free sales or not. As one bill was not passed until 2009, the participating manufacturers may argue that New Mexico did not comply until then, but they will always devise an argument that the state is not complying. Mr. Thomson said that the requirements are always accelerating like an "arms race". In the first regular legislative session of 2009, the legislature passed Senate Bill 219, as amended, sponsored by Senator Howie C. Morales, which sought to strengthen the enforcement of and clarify New Mexico law relating to the MSA. The major issue was that if products are stamped, nonparticipating manufacturers must pay into escrow, which is a mere clarification of what the attorney general already believed to be true. A committee member explained that participating manufacturers were not opposed to the bill in the 2009 regular session, but nonparticipating manufacturers wanted to defeat the bill. One nonparticipating manufacturer had a concern that by making this requirement, the cost of product would increase and it would run it, New Mexico's only tobacco manufacturer, out of business. The effective date for Senate Bill 219 was July 1, 2009.

A lot of manufacturers have increasingly requested tax-exempt stamps. The attorney general plans to use additional subpoena authority to determine whether certain tobacco manufacturers have complied. The main concern is that it would present a burden to small business and an advantage to scofflaws. The Attorney General's Office audits these reports independently of taxation and revenue, though it reviews the Taxation and Revenue Department's (TRD's) audit as well. It also looks at every manufacturer's report and takes action against violators.

In response to a question about what New Mexico had done to comply in 2003, Mr. Thomson stated that he could not disclose work product, but that the attorney general believes the state complied with the MSA.

A question was posed as to whether New Mexico is still receiving its share of payments pursuant to the MSA. Mr. Thomson explained that it is, but the amount received in 2003 is being disputed in arbitration. It has taken a while because of procedural concerns with arbitration. The years 2004 through 2007 are in dispute as well. The concern is that New Mexico will have to repay its 2003 allocation.

The committee discussed the effect of the size of the pool of MSA states participating in arbitration. If some states have a judgment against them and some do not, the pool may be smaller. New Mexico's portion of the MSA payments would thus be deemed to be smaller, and the state would have to repay some of the payment it received up to its allocable share. If New Mexico is among five states that were found noncompliant for $50 million, for example, then it would be responsible for repaying one-fifth of the $50 million ($10 million). If New Mexico is among 10 states that are found noncompliant, then its obligation will likely be less.

When asked about the cost of the ongoing arbitration, Mr. Thomson replied that New Mexico is paying $1 million for the arbitrators alone, and the Attorney General's Office has requested $300,000 in supplemental funding from the Legislative Finance Committee (LFC) to cover these costs. The National Association of States' Attorneys Generals did test trials, looking at factors such as whether a state dedicated part of the settlement money to its attorney general for enforcement.

A committee member remarked that New Mexico cannot use MSA funds to pay for arbitration costs because statute restricts use of the money. However, the state can use general fund money for costs. The attorney general has requested an appropriation for a full-time tobacco attorney.

The state's communication with Indian tribes, pueblos and nations (tribes) was discussed next. It was explained that the tribes did not, as a whole, oppose the tax stamp legislation when it was passed. There was concern about providing an advantage to nonparticipating manufacturers, and thus the TSROC met with the tribes and consulted with states that had entered into agreements with tribes. The tribes told the legislature they did not want legislative involvement but government-to-government interface. In Arizona, the tribes impose a tax, and they may keep it or share it with the state. New Mexico made a commitment to the tribes that it would not pass anything requiring tribes to tax tobacco.

Since the 2009 regular session, the Attorney General's Office has met with the governor's counsel, which believes this to be a sovereign-to-sovereign issue and not something with which the attorney general should be involved, though the Attorney General's Office offered assistance to the governor's counsel. Mr. Thomson explained that the Attorney General's Office has developed informal relationships with tribes that have been very fruitful. It offered its directory of manufacturers to the tribes.

Tribes agreeing to the MSA get additional revenue. There are circumstances in which tribes have a stamp that they retain. New Mexico uses a tax-exempt stamp to identify products and track the escrow payments that manufacturers make.

Mr. Thomson then discussed the amount of revenue available to New Mexico if it prosecuted the nonparticipating manufacturers for violations of state law. He explained that the Attorney General's Office does not enforce the tax code; it enforces the escrow statute. The Attorney General's Office believes that, for those circumstances when it brings lawsuits to recover the escrow for those manufacturers not stamping tobacco products or not paying into escrow, there is a direct revenue correlation: New Mexico gets neither tax revenue nor escrow. The Attorney General's Office has referred a "considerable" number of these cases to the TRD. When asked for clarification on this considerable number, Mr. Thomson estimated that this year, there may have been three fairly substantial cases referred to the TRD. The Attorney General's Office does not know how many cases the TRD has sought to prosecute. If the TRD can collect, it would be in the area of tens of millions of dollars. Mr. Thomson stated that the Attorney General's Office has a good relationship with the TRD and that the Attorney General's Office encourages its focus upon tobacco enforcement because of "significant" revenue loss due to misapplication of stamps. The Attorney General's Office has provided a list (see tab 2, handout) of its civil litigation efforts.

The state does not use the money placed in escrow unless down the road it sues manufacturers to recover the funds held in escrow. Tobacco manufacturers can recoup their interest annually and recoup the principal after 25 years. After this arbitration ends, the Attorney General's Office will consider whether the state should go after these manufacturers.

A question was asked as to where the nonparticipating manufacturers are and whether any are Native American companies. The Attorney General's Office attendees replied that most manufacturers are New Mexico corporations and are not Native American-owned. The Attorney General's Office asked in this legislation that the manufacturers designate an agent to be sued. A lot of these were foreign manufacturers, against whom the law is impossible to enforce. The Attorney General's Office can actually ask for a bond up front until it trusts that the escrow payments are made. One corporation is Canadian; another is New Mexican; a couple are in New York state; one is in South Carolina; and some are overseas.

The Attorney General's Office will be filing two new actions to collect escrow and penalties from two tobacco companies that have significant escrow obligations and, the Attorney General's Office believes, tax liability. This contradicts what some tobacco manufacturers claim when SB 219 was being debated in the 2009 legislative session: that the state is not enforcing the MSA or the law pursuant to it.

A discussion ensued regarding the applicability of some federal contraband legislation that New York City is using against tobacco manufacturers. The Attorney General's Office representatives explained that New York City is "unique in many ways" and has its own separate cigarette tax; an individual purchasing cigarettes in New York City pays a state tax, a federal tax and a city tax. Contraband is flowing into New York City, according to the Attorney General's Office. When people are dealing in contraband, their reward increases because they are not paying those taxes. In a recent case, *City of NewYork v. Golden Feather*, New York City sued a tribal smoke shop for violation of the federal contraband act. The city was granted an injunction. New Mexico has not made an independent assessment as to whether to use this federal statute.

A legislator made the observation that New York City appears to be doing a better job on reducing youth smoking. The Attorney General's Office representatives explained that price is an essential factor in curbing youth smoking. New Mexico has one of the lower tobacco tax rates and has a long way to go to reach New York City's tobacco tax rate. There is a correlation between lower youth smoking and the tax rate. As usage drops, the Attorney General's Office predicts that the anticipated effect will be lower payments to states because of lower smoking rates.

A committee member observed that the most effective way to reduce youth smoking is increased taxes, according to the federal Centers for Disease Control and Prevention (CDC). Yet, higher taxation provides an advantage for illegal sellers, as the reward to scofflaws who evade these taxes is increased. The Attorney General's Office and the TRD must be commited to enforcing the tobacco regulation and tax laws.

Attorney general opinion request: A legislator had requested an opinion by the Attorney General's Office, to which Mr. Thomson explained it was not able to respond because of pending litigation and investigations.

In the handouts, tabs 3 and 4 are indictments from the State of Washington. Paragraph 20 addressed conspiracy regarding certain activities that occurred in New Mexico. This delves into the issue of a federal trade zone — whether there were civil or criminal liabilities for individuals bringing in non-directory product. The Attorney General's Office is looking carefully at these cases.

New issues relevant to tobacco use cessation:

1. Electronic cigarettes. These are battery-powered devices delivering a vaporized nicotine solution. It is a reasonable argument that these are not cigarettes because they do not contain tar and do not emit smoke. It is debatable whether current law allows regulation of these. Advertisements call them smoking cessation products, with which Mr. Thomson disagrees.

The federal Food and Drug Administration (FDA) has issued a warning against using these and to watch for children's use.

2. Baggies. Now cigarettes are put into groups in bags, and one cannot identify a manufacturer on the bag. These are sold at flea markets, etc. There are concerns about the volume of these.

3. Internet sales. The Attorney General's Office may want to introduce legislation prohibiting internet sales. It investigates which internet companies are selling products to noncompliant vendors and contacts them. The representatives from the Attorney General's Office explained that New Mexico may need to expand this practice.

2010 payment projections. The Attorney General's Office's most conservative estimates include the scenario in which all of the participating manufacturers withhold what they are entitled to withhold or put in disputed payment accounts. They are disputing the years 2003 through 2007, so the office believes they will do so. Based on that, New Mexico's allocable share will be approximately $33,925,000. The Strategic Contribution Fund, to which New Mexico is entitled as a first MSA party, will provide around an additional $7 million. Inflation, usage and bankruptcies among manufacturers (coming out, going in) are all factors that may increase or decrease these numbers. The Strategic Contribution Fund sunsets at some point. Last year, it provided roughly $6 million.

Federal CDC Recommendations and Performance of New Mexico

At 11:30 a.m., Cynthia Serna, regional grassroots development director of the American Cancer Society, made a report about new CDC recommendations and how New Mexico has measured up vis a vis CDC recommendations. The Children's Health Insurance Program (CHIP, formerly known as the State Children's Health Insurance Program or SCHIP) expansion included a $.62 per pack tax increase. This is important for decreasing tobacco use. While the tax increase was a federal initiative, tobacco manufacturers' price increases have also helped.

Ms. Serna discussed the FSTPCA passed in June 2009, giving the FDA regulatory authority over tobacco products. She stated that federal health care reform bills currently under debate may have an effect upon tobacco use cessation. There is talk of requiring insurance companies to provide preventive services with no cost-sharing for enrollees; these preventive services would likely include cessation drugs in formularies.

There is a funding opportunity pursuant to the federal American Recovery and Reinvestment Act of 2009 (ARRA) stimulus bill for a new communities putting prevention to work program in New Mexico. It is a very competitive selection process for seeking $373 million, and a very limited number of grants will be provided. There is a limit of 30 possible programs to be awarded. It is also open to cities, counties and tribal entities. Larry Elmore anticipates applying for a grant, which lasts for two years. The CDC is administering this program and has made it clear that the CDC cannot supplant existing funding. CDC money cannot be used for things like nicotine replacement therapy.

The CDC has outlined four main goals (see handout; p. 2, slide 3) that are supposed to maximize interventions to reduce use. Their initial 1999 document recommended that New Mexico make a minimal investment of $13.7 million; they changed this upon revision and looked at best practices costs in specific states (cost of media, etc.). New Mexico should invest $23.4 million a year on five categories, which is $11.95 per capita. Thus far, New Mexico has done a pretty good job; the Department of Health (DOH) regularly examines how it allocates money. When the DOH felt that youth use was leveling, it shifted additional funding into youth-focused media. It also has a free help line. CDC money cannot be used for nicotine replacement therapy, but the DOH funded nicotine replacement therapy and used the CDC funds in media campaigns, which increased the calls to the help line.

The DOH's Tobacco Use Prevention and Control (TUPAC) program funding shifted considerably after the Dee Johnson Clean Indoor Air Act passed. The DOH is seeking to address disparities, some of which arise because tribes are not covered by the Dee Johnson Clean Indoor Act. Therefore, the DOH allocated more money to tribal efforts.

New Mexico funding for tobacco programs is around 40% of the CDC's recommendation.

The coalition supports current-level funding for fiscal year 2011, but would like to increase the funding if the economy improves (see letter in handout folder). It also wants a tobacco tax increase to supplant continued diversion of tobacco settlement money.

New Mexico is thirty-first among the states in tobacco taxes.

There are 33 states that have passed strong statewide smoke laws, most recently in North Carolina, which is a major tobacco-producing state.

The presenters drew the TSROC's attention to a one-page FSPTCA summary as well as extensive discussion of FSPTCA provisions and their effects. They also noted that page 13 of the slide handout shows the implementation time line.

Ms. Serna noted the September 29, 2009 deadline for public input on FDA rulemaking.

The CDC advises a cautious approach to introducing legislation because of potential national legal challenges. While the FDA has authority to regulate tobacco, states still have the responsibility of enforcing state laws.

Revenue Projections

Tom Clifford, chief economist with the LFC, testified regarding revenue projections. Mr. Clifford reminded the committee that the MSA was signed in 1998; the agreement was between four of the larger tobacco manufacturers to compensate states for tobacco-related expenses. Payments pursuant to the MSA are made in perpetuity.

In 1999, the legislature passed Sections 6-4-12 and 6-4-13 NMSA 1978 so that the state complied with the MSA. Tobacco manufacturers had the choice of paying pursuant to the MSA or paying an equivalent amount in escrow until states win a settlement within 25 years.

Any funds received are desposited in the Tobacco Settlement Permanent Fund (TSPF). Balances may be appropriated to cover a deficit in general fund dollars, but ONLY IF balances in other enumerated funds are inadequate to cover the deficit. In other words, the TSPF is the "last" reserve.

At the end of fiscal year 2010, there is expected to be $120 million in this fund. A committee member clarified that one of the reasons New Mexico created a permanent fund is that the MSA has some big concessions to tobacco manufacturers. There was no requirement that states spend on anti-smoking or health; some states even used MSA funds to fund tobacco farmers.

The other thing that happened to create a disadvantage to states is that the allocable share is tied to *domestic* profits for tobacco manufacturers, not to international markets. As tobacco use declines, state revenues decline. This is why most states, even in perpetuity, are counting on the money for 25 years. Hence, New Mexico puts money in the TSPF to pay its share in perpetuity as it grows. Yet, deficits have intervened, and the TSPF has been sometimes used for other reasons. Governor Richardson wanted to close the TSPF, and the legislature agreed to divert money for four years. Last year, another two-year diversion was made. The corpus is growing; New Mexico is not using the interest from it. The state is using only 50% of the new money that comes in for the programs rather than the TSPF corpus.

Nonparticipating manufacturers have a strong incentive not to join the MSA, as they would have to make up payments lost during the time before they joined. Also, escrow will entail a "huge amount" of litigation.

<u>Budget considerations: p. 2 of handout</u>

An 8.5% volume reduction is expected due to the federal excise tax increase, then another 7% reduction next year.

Beginning in fiscal year 2006, some participating manufacturers began withholding from states' payment amounts due to what they attributed to the states' lack of diligence in MSA enforcement. The Attorney General's Office is concerned because some of the largest participating manufacturers may be withholding $6 million.

The downside risk is that revenues could be lower than forecast — a risk that was not incorporated in the scenario.

In 2009, the state received a one-time $3.2 million payment from some of the manufacturers. Another positive settlement would represent an upside risk.

There are two offsetting risks: a positive risk would be to win settlement on all withheld payments around $20 million; a negative risk would be that arbitration might result in states paying back money to participating manufacturers, and New Mexico's share of the repayment might exceed the amount received in any given year.

The basic allocation is $48.7 million, of which $3.1 million was withheld. Previously, $3.22 million was withheld and has now been released. A total of $48.66 million went to the program fund. This was about $4 million over what had been forecast, most of this being due to the $3.22 million one-time payment.

In fiscal year 2010, the same base payment is expected, with $3.2 million being withheld, bringing it to $45.53 million.

In fiscal year 2011, revenues are expected to decrease, with a base of $47.76 million predicted (lower because of the federal excise tax), with a total distribution of $22.28 million.

A committee member suggested that Mr. Clifford accompany the TSROC on December 4 when it testifies before the LFC regarding budgetary matters.

A question was asked regarding why the distribution to the program fund drops from $45.5 million in fiscal year 2010 to $22.2 million in fiscal year 2011. The difference is going to the general fund to help with the budget shortfall. Otherwise, $22.8 million would have gone to the program fund. In fiscal year 2009, the program fund received a nonrecurring $3.22 million.

Mr. Clifford offered to modify the table in the handout to show diversions correctly.

TSPF Performance Review and Projections

At 2:05 p.m., Charles Wollmann, public information officer with the State Investment Council, made a report regarding the TSPF performance review and projections, guiding the committee through the spreadsheets he provided. Mr. Wollmann discussed how the TSPF is invested per the handout spreadsheet. He explained that the TSPF consists of approximately $130 million currently.

Mr. Wollmann identified some long-term targets for management of the TSPF. In 2007, the large cash equity was the result of when the investment officer decided to take a conservative position based upon risk assessment, believing the state was headed toward recession. This helped a fair amount until the last several months; there will likely be an allocation study to decide whether this is appropriate.

There has been $15.8 million in total income since 2000, which Mr. Wollmann explained is "not bad" considering two market crashes since then. There have been 3.4% in returns for the last five years; the Standard and Poor's Index was down 2.2% for the past five years. Stocks and bonds would have produced 0.9%. The investments protected the fund for the most part.

The current value is $126.7 million as of 8/31/09; peak value was $137.8 million (2008). The fund is NOT self-sustaining, meaning it could not generate enough income so that annual distributions of $32.5 million from those earnings could be made. To get to that size of a fund, 8% growth a year would be necessary. Many believe 8% is impossible, considering the last decade. The committee has to consider whether to rely on smaller distributions or to grow the fund. Had there never been a diversion, it would not take until 2032 to become self-sustaining. According to lobbyist Linda Siegle, it would have been self-sustaining in 2017 at 6% to 8% without the diversions. In 2002, it was predicted to be self-sustaining in 2016.

In response to the question as to what amount was lost in the economic crisis, Mr. Clifford answered that the fund peaked at $137 million in June 2008; it is now at $130 million. Conservative investing served it well, but it may have to be reconsidered as the economy improves. Mr. Clifford identified the state investment officer as the person to whom credit should be given for keeping the fund solvent.

Review of Fiscal Year 2009 and Fiscal Year 2010 Program Funding Levels

At 2:15 p.m., Ms. Mitchell explained the charts she had included in the committee's folders, including historical data since the TSPF's inception. It shows the last few years' recommendations by the TSROC and the LFC and final appropriations. Referring to the yellow chart handout, she explained that it contains the actual appropriation amounts for fiscal years 2009 and 2010. The purple handout sheet shows alternatives with cuts to programs.

The committee recessed at 3:21 p.m.

<u>Friday, September 25</u>

Fiscal Year 2011 Funding Recommendations

The meeting was called to order at 9:55 a.m. The committee reviewed each appropriation for the current fiscal year and adopted new recommendations for fiscal year 2011, including increases in funding for the breast and cervical screening and treatment programs, research in genomics, biocomputing and environmental health, lung and tobacco-related disease research and the tobacco cessation and prevention program for Native Americans.

A motion to appoint a subcommittee to the committee to revisit the committee's recommendations if the Legislative Finance Committee revised its revenue projections was adopted.

A motion to endorse cigarette and tobacco products tax increases was adopted.

The committee discussed the implications of the current dispute with tobacco manufacturers over the state's enforcement efforts under the Master Settlement Agreement. The Attorney General's Office is currently in arbitration with tobacco manufacturers over the state's enforcement efforts in 2003. If the state is found not to have diligently enforced its tobacco statutes, it is possible that New Mexico could be forced to pay back its entire allocable share of tobacco settlement revenue for 2003. Tobacco manufacturers have also initiated challenges to the state's enforcement efforts in all subsequent years, increasing the state's total potential liability. The committee agreed that until the results of the arbitration are made known and New Mexico's share of financial liability, if any, is established, the committee would oppose the diversion of tobacco settlement revenue to offset general fund appropriations.

The committee adjourned at 11:35 a.m.

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